

# Business and Economy Review

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## The Moldova's Economy in 2006

## **The BER Team:**

Valeriu Prohnițchi

Alex Oprunenco

Sorin Crudu

Nicolae Zaharia

## **EXPERT-GRUP think tank**

web: [www.expert-grup.org](http://www.expert-grup.org)

email: [info@expert-grup.org](mailto:info@expert-grup.org)

address: MD-2068, Republic of Moldova, Chisinau, A. Russo, 1 str., of. 318

tel./fax.: /37322/ 43-82-80,

tel. /37322/ 43-82-45

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## Summary

**Output.** During 2001-2005 the Moldovan economy grew about 7% annually. This tendency has fuelled the illusion that Moldova is on the highroad. In fact, the rapid expansion of consumption and imports and the increase of economic imbalances determined rather an overheating of the economic system than an increase of its production capacity. The economic growth was restricted to large urban areas, while the small towns and villages languished. The growth was capital-intensive, but went along with the jobs shedding and amplification of migration. External markets remained undiversified and the exports – limited to a narrow range of products.

In 2006 the external shocks served as a rude awakening. The establishment of external trade barriers and the new prices to energy resources contributed to the slowing of economic growth in 2006, estimated by EXPERT-GRUP at 3.8-4.0%. The growth of the capital investments by 22-24% represents one of the relieving tendencies. In 2007, the GDP growth will range within 6.0-6.5%. This forecast assumes that the added value will rise in agriculture by 6%, in processing industry by 4%, in constructions by 7%, in trade by 4%, in transport and telecommunications by 6%. The net taxes on product and imports will go up by 10%. Maintaining the investment rate and expanding the investment in productive activities represent an indispensable condition for the economic growth sustainability throughout 2007-2008.

**Industry.** The decline in wine (-50%) and brandy (-36%) production has been totally influenced by the closure of traditional markets. The deadlock of these two industries generated spill-over effects in sectors producing glass and carton package, both falling about 8%. However, the economic

recession was determined by endemic factors as well, which do not have any connection with economic barriers mounted by Russian Federation.

This is the case of sectors like tobacco processing, dairy, vegetable oil and confectionary production, and machine construction. In 2006 the production growth was common for industrial companies affiliated either with the European sale channels (leather, carpet, medical and optical equipment production) or with constructions sector (cement and metal goods production, the stone cutting and shaping). The industry has chances to recover its handicap in 2007 by re-launching the exports to Russian markets and a more aggressive sales expansion to western markets. The wine quantity that will be exported in 2007 will not to be comparable with those from previous years due to the more rigorous control of the quality of Moldovan products. EXPERT-GRUP estimates that in 2007 the industrial growth will lie within 3.5- 4.5%.

**Agriculture.** The sector suffered to some extent in the wake of the interdiction imposed by Moscow in 2005 on vegetal and animal exports from Moldova to Russia. However, the main causes of the agriculture economic stagnation in 2006 stem from the agriculture sector itself. The most serious problems reside in the delay of implementing new technologies and the prevalence of low value added goods. The GSP+ trade regime or the Autonomous Commercial Preferences cannot be useful for companies not certified according the European standards and with a production structure limited to the low value added crops.

For 2007, EXPERT-GRUP forecasts an agriculture growth of 4.0-4.5%.

**Constructions.** This sector showed in 2006 a brisk growth of 20%. The prices reached a new peak and the number of operators within the sector spectacularly increased. At the same time, more companies understand that the current price level (800 USD/m<sup>2</sup>, December 2006) will be hardly supported by the market. In 2006, for the first time in last five years, the demand for apartments fell under the supply level. This situation will compel the operators to offer dwelling with the price-corresponding quality and to participate in developing new instruments for mortgage sale and for making the apartments more accessible to the population.

**Consumption.** In 2006 Moldovans remained avid consumers, but a certain moderation of the consumption sentiment was noticed. The volume of services rendered to the population increased by 6%, and the volume of sales – by 9% (as compared to 8.5% and 13%, respectively, in 2005). At the same time, the robust consumption growth is mostly relevant for big cities, while in rural areas and small towns the consumption is constrained by low income. In 2004-2005 the poverty incidence increased from 26.5% to 29.1%, reaching 32-33% in 2006, according to our estimates. The assessments made by EXPERT-GRUP in January 2006 attested the lowest Consumer Confidence Index in small towns. Repeated assessment in August 2006 showed a decline of negative expectations in this residence area. The negative dynamics of consumption sentiment was noticed in rural areas as well, but on a less alarming level.

If in 2007 the economic growth does not expand geographically, the income disparities between the inhabitants of rural areas and small towns, on one hand, and those of big cities, on other hand, will increase.

**Budget.** The halt of wine exports to Russia has brought about budgetary losses estimated at 400 million MDL, but the impact has been far from being destructive. This is explained

by the quasi-total budget dependency on the indirect taxes on consumption, mainly VAT, and which do not depend in short-term on the productive sector's evolution. Total revenues of the public budget surpassed the planned level by 1.7% (reaching 17.85 billion MDL). However, the annual expenditures were executed to 97% of the planned one, while in November 2006 expenditures were executed only to 85% of the plan for 11 months. Lack of efficiency and transparency in spending the public money was a feature of the previous year, common for all relevant actors: from Parliament to the local public authorities and institutions. Large amount of public money was used for direct or indirect subvention of some state (Air-Moldova) or public (Teleradio-Moldova) companies.

**Money.** In June 2006 the Law on the NBM was amended. In its current version, the law provides for a greater institutional independence of the Bank, establishes the control over the inflation as the main objective of the NBM and excludes the possibility to credit the state by the Bank, inclusively by acquiring state securities on the primary market. Pressed by a highly inflationary environment, on 28 September, the NBM increased its basic interest rate from 12.5 to 13.0% annually, on 16 November the rate raised to 14%, and on 1 December – to 14.5%. The purpose was to absorb the excess of monetary liquidity on the market. Nevertheless, the task of fighting inflation is very difficult because of the constant inflow of foreign currency. Besides, the NBM cannot control directly the growth of the commercial credit. For controlling efficiently the inflation in 2007-2008, the NBM will have to diversify its portfolio of monetary policy tools.

**Banking system.** Among the most important evolutions of the 2006 year is the entrance of foreign investors on banking market. Starting with 2007 they will propel

the systems' activity. Actually, the first signs appeared already in 2006, the local banks being compelled to show more creativity in promoting new banking products. The interest rate on the deposits in Moldovan lei decreased to 11.93% relative to 12.99% in 2005. The rate of interest on credits declined slower, from 18.93% in 2005 to 18.18% in 2006. In 2007 the competition will become tighter, as additional new players are expected to enter the market of banking services.

**Financial markets.** The treasury bonds market has shown extraordinary dynamics, being influenced by the processes that took place in the real economy and banking system. After that in February was registered the lowest interest rate (1.83%), in December the interest reached 12.9%. The interest's growth was fuelled by the raise of inflation, the growth of interest on interbank credit and the reduction of available banking liquidities. As result of some fundamental (supply-demand) and speculative (the rumours about the devaluation or even the change of national currency) factors, in January-August the Moldovan leu depreciated against the dollar. A higher demand for foreign currency was determined by more expensive imports. At the same time, the drop of exports returns, the increase of bank assets in foreign currency and the lower sales of hard currency from individuals left the supply below the expectations. In September-December the leu increased its value, regaining practically the positions from the beginning of the year. This dynamics was influenced by greater inflow of dollars and euros from individuals, a certain expansion of exports to western markets and a deficit of national currency in banks.

**Foreign trade.** Terms of trade of Moldova worsened considerably in 2006. EXPERT-GRUP estimated the total value of exports at about 1071 million USD, lower than in 2005 by 2.0%. The value of imports continued to increase fast (by 13.6%), amounting to 2326 million USD. These evolutions caused a

deterioration of the trade balance, the deficit reaching dizzy lows of 1555 million USD. Such evolution resulted from the trade shocks that affected both exports (embargo on alcoholic drinks imposed by Russian Federation, ban of meat imports, imposed by Ukraine) and imports (the rise of prices for the gas imported from Russian Federation). On the other hand, the western commercial influence (GSP+, later joining CEFTA) did not bring the expected results. The exports to European Union cheered up a little in the second half of the year: (+11.2%). In 2007, EXPERT-GRUP does not expect an impressive exports expansion in any direction.

**Global oil market.** In the first half of 2006, the prices for oil maintained the ascending trend, because of some economic (a significant rise in demand in China and India) and geopolitical reasons (the conflict in Lebanon, the risks linked with the nuclear Iranian case, a decrease of oil extraction in Nigeria). The price for oil has reached the top of 78.4 USD/barrel. This tendency reversed in August, when the geopolitical risks receded. A certain influence over declining oil prices had the favourable weather conditions and the reduction of China's demand. In December the oil price started to rise again. In a short-term perspective, the majority of pundits are expecting the expensive oil trend to keep on the level of 60-65 USD/barrel.

**Global wheat market.** In 2006 have been registered the lowest final wheat stocks in the last 25 years. As a result, the prices on wheat rose. EXPERT-GRUP is expecting that in the next future the price rising tendencies will persist, which could favour the Moldovan agriculture.

**Trade partners.** During 2006, the evolution in the economies of the main trade partners was favourable for a possible expansion of Moldovan exports. Romanian, Russian and

Ukrainian economies grew by 7%, and the average economic growth in UE was 3%, exceeding forecasts. But, for Moldovan exporters to capitalize on these positive tendencies, serious efforts for overcoming non-tariff barriers and enhancing the competitiveness of Moldovan exports has to be undertaken by authorities and producers.

**Prices.** In 2006 the inflationary tensions have escalated. The Consumption Price Index (CPI) increased by 14.1%, relative to 10.0% in 2005 and 12.5% in 2004. The Industrial Producers Price Index increased by 12.7%. The augmentation of producers' prices has exerted pressure on consumption prices as well. Inflation is also the result of expansion of demand financed by the salaries' increase, the remittances from abroad, the income coming from business, and consumer credits. The greatest influence on the CPI growth came from the administrative rise by 32% in the prices for public utilities (gas and drinking water supply). In 2007 inflation will be determined by a range of factors. The high inflation in 2006 will fuel the inflationary expectations. The rise of salaries and the income from abroad will accelerate inflation through consumer demand. Also, a new rise of prices for the gas and electricity is expected. The intensification of competition in the banking sector will result in a gradual decline of interest rates, thus increasing the demand for consumer credits even more.

**Labour Market.** In 2006 the labour force surveys showed a decrease of the number of people who emigrated to work abroad. If in

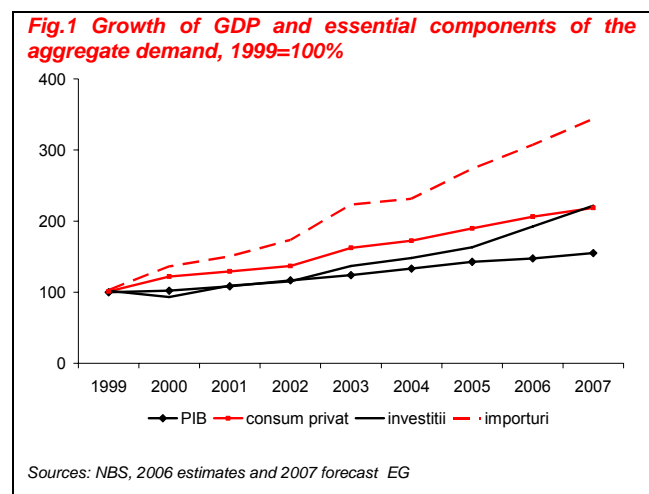
Q3-05 this number was estimated by National Bureau of Statistics (NBS) at 420 thousand, then in Q3-06 – at 320 thousand. However, this statistical decline of the number of emigrants does not seem to be real and is not reflected in a corresponding rise of the economically active population, which increased only by 23 thousand. The analysis of tourist outflows data, the field observations and the press articles suggests that the bulk of emigrants did not reduce in 2006.

Despite the economic difficulties and external shocks, the real average salary in 2006 rose by 15.5% (as compared with 6.8% in 2005). This progress was brought about by an increasing labour productivity in economically efficient sectors (constructions, financial services, trade, and some industrial branches) and by the administrative rise of the budgetary financed wages. In November 2005 - November 2006 the employees from the public administration sector got the highest rise of wages in economy, about 50% in real terms. The salaries' rise caused the emergence of distortions within the budgetary system: the average salary in the public administration sphere is currently twice higher than the salary received by a teacher or a doctor. We see no plausible criterion that would justify such discrepancy between salaries in the public sector.

## Output

For Moldovan economy the 2001-2005 years was a period of a “highroad illusion”, the GDP increasing on average by 7.0% annually. The economic dynamics was mainly supported by a perky expansion of the private demand for the final consumption goods, that boosted by 9.4% annually. The consumption was financed by a rapid rise of real salaries, emigrants’ remittances and profits. Starting with 2005, the importance of the consumer credits has also increased. During the same period, the capital investments rose by about 12% annually. These performances are apparently quite good.

Nevertheless, the traditional macroeconomic indicators do not reflect the bad quality of the economic growth in Moldova and the overheating of the system. The Moldovan productive sector is still very fragile, that is why the intensification of domestic demand is not followed by a similar dynamics of domestic supply. The people’s “thirst” for consumption was chiefly satisfied by imports, which in 2001-2005 showed an exceptional growth, by 15.2% on average annually and that outran all other components of the aggregate demand (Fig.1).



Some considerations about the quality of Moldova’s economic growth should be added. Geographically, the economic growth is restricted to big urban areas, while the rural economy stagnates. Such model of economic growth does not ensure rising incomes for rural inhabitants and does not allow a sustainable reduction of poverty in a country where more than 60% of population are rural dwellers. Also, the economic growth was very capital-intensive, followed by jobs shedding and the amplification of migration. The external markets were not diversified, and exports are represented by a narrow range of products with a low value added.

Such model of economic growth usually results in a “forced landing” of economy, its stabilization being possible only through demand contraction, not through supply extension. The hardness of “landing” will depend, to a large extent, on the capacity of the government and private companies to augment the aggregate supply on the market. There are two basic ingredients to avoid the “hard landing” of economy or to reduce its consequences to a minimum. At the government level, it is necessary to cut red-tape and advance regulatory reform to “unleash” the private sector and to attract foreign direct investments in economy, including as green-field investment. As for the companies, they should faster implement advanced management and marketing models and internationally recognized quality and technical standards.



The external trade shocks from 2006 were a “cold shower” that, as we hope, will put an end to the illusions and will compel the government and the producers to adopt more efficient political and corporative strategies.

Even if a deep systemic recession was avoided, two economic sectors – agriculture and industry – posted negative growth in the first three quarters of 2006, – 2.6% and respectively, – 7.0%. The economy remained on the growth path only due to services which grew by 9.4%. But in this sector strong qualitative distortions come out as well. Especially, the constructions sub-sector increased by about 16%, but this progress stems from the boost of civil constructions with dwelling purpose (this means unproductive), that in addition are represented by urban ‘elite’ constructions (inaccessible for general public). The 18% growth of another important sub-sector, transport and communications, was ensured only by communications, while the segments of auto and railroad transport declined. Within the communications, an essential part of the progress was ensured by the mobile communications represented only by two operators.

According to our preliminary estimates, the 2006 ended up with a growth of 3.8-4.0%. In 2007 the growth rate will vary within 6.0-6.5% range and will be possible only after the removal of factors impeding a stronger growth in 2006. This forecast bases on the following assumptions: the agriculture will increase by 6%, processing industry – by 4%, constructions – by 7%, trade – by 4%, and transport and communications – by 6%. Other sectors will go up on average by 5%, while the net taxes on product and imports by 10%, securing about 30% of the GDP growth.

## Industry

In 2006 the industrial enterprises of all forms of property produced an output with a value of 22 billion lei in current prices, which is 6.9% less than in 2005 (fig.2). In 2006 the industrial sector went through a serious recession, similar to that registered in 1996. Although the extractive and energy sub-sectors went up (by 23%, and respectively, by 6%), the industrial sector posted a negative growth owing to the processing industry, where the output in real terms was 8% lower than in 2005.

The growth rate of the food and drinks industry stayed at –19%. The wine and brandy production fell by 50% and, respectively, by 37%, determining to the largest extent the overall recession of the food industry. Nevertheless, even if the alcoholic production would have remained on the 2005 year level, the growth of the food industry had been feeble (about 1.5%) due to problems existing in other important branches, such as vegetable oil, dairy and confectionary processing. Their decline has no connection with the trade barriers raised by Russian Federation in 2005-2006.

At the same time, the negative dynamics of the alcoholic production branch brought forth negative consequences to other afferent branches as well. The glass and carton package production declined by 7%. Another important factor that negatively influenced the glass production (and also the cement production) was the rise of price for natural gas.

Machinery sector suffered a recession of 3% mainly due to producers of pumps and agricultural machinery. These two branches, though possessing a huge potential for development, by now have not managed to capitalise on the comparative advantages they possess in relation to the competitors from the region (the main advantage is lower production costs).

In 2006 it became clear that the industry of tobacco products transformed definitely into a “falling star”. The production growth indexes of this branch display the following trend: +1% in 2003, -5% in 2004, -4% in 2005, and -23% in 2006. All attempts of the Government to save this branch, including by direct subsidies to the companies that produce and/or process tobacco, are inefficient and even counterproductive. The only chance for the branch to survive is to ensure competitiveness of production and vertical integration, which could be possible only by the privatisation of the main processing units. Moreover, in a long-term perspective, this branch is doomed due to the intensification of the global anti-smoking campaign, campaign to which the Government of Moldova will have to adhere more convincingly.

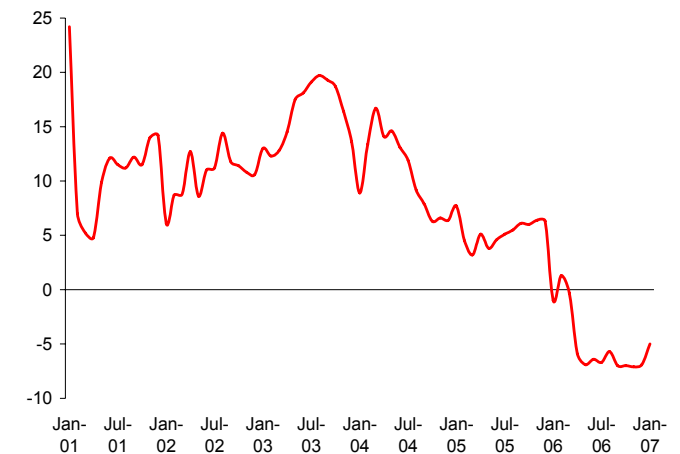
On the contrary, some sectors have reported considerable increase. This fact is explained by many causes, including by the affiliation of domestic companies to the international companies targeting EU market with the developed distribution chains at hand. For instance, the leather production increased by 80%, that of medical and optical equipment – by 70%. The carpeting factories increased the sales volume by approximately 26%. The strong expansion of the constructions sector favoured the increase of the production of construction materials by 38%. Nevertheless, the “industrial year” 2006 ended on an even more pessimistic mood than it began.

Industry has chances for recovering in 2007 the handicap by resuming the exports to the Russian market and by a more aggressive sales expansion to the Western markets. Obviously, due to a special attention paid to the quality of Moldovan products the quantities of wine exported in 2007 will not be comparable to the ones from the previous years. The diversification of the sales markets and the recovery of wine-making could give a boost to the adjacent sectors as well. The EXPERT-GRUP cautiously estimates that industrial production will increase at 3.5%-4.5% rate in 2007.

## **Agriculture**

The year 2006 was a period of many hopes and little results for the agricultural sector. The evolution of the sector confirmed once again the volatile character of the agricultural activities in Moldova (Fig. 3). According to the preliminary estimates, the agricultural production gained in 2006 11 billion lei, i.e. 96% comparing to the

**Fig.2 Industrial output growth, %, cumulative**

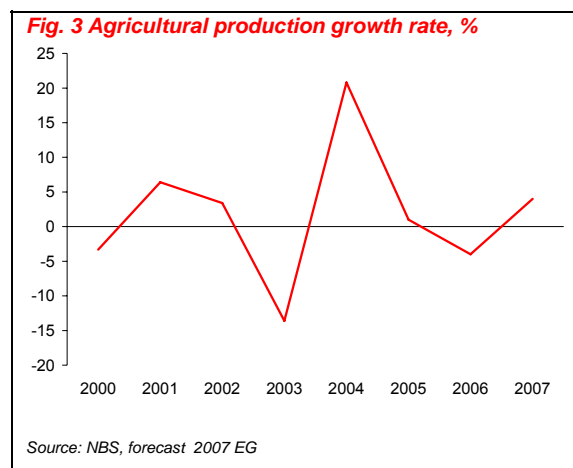


Source: NBS, estimates January 2007 EG

previous year. The reduction of the agricultural production was determined by the decrease of vegetal production by 8.9%. According to the preliminary data, 371 thousand tons of fruit were harvested in 2006, which is 17 thousand tons less than in 2005. The harvest of vegetables was of 459 thousand tons, which is 15 thousand tons more than in 2005. According to some estimates, the harvest of grapes was approximately 18-20% less than in the previous year.

The total harvest of cereals decreased about 20%. The cereal market was bolstered, to a certain degree, by the decision of the Moldovan Government allowing exports of cereals without the compulsory registration of the contracts at the Universal Commodity Exchange of Moldova. This decision has at least two good implications for the grains market of Moldova:

- The exporters will avoid some additional taxes that lead to the increase of the final price and the decrease of the international competitiveness of the products;
- There will be less administrative pressure and control over the companies, which will ensure a higher degree of accessibility of the market by the sellers as well as by the buyers.



During the previous year, the issue of quality of agricultural production was even more serious than the decrease of the volumes. The delay in implementing new technologies of cultivating high value added products is the most strident issue of Moldovan agriculture. The great majority of the enterprises from this sector are led by the managers that do not know how or do not want to produce what the market demands. As much as new sustainable relations with the European partners are concerned, they mostly depend on steadiness of supply, both in quantity and quality terms. In 2006 we witnessed the first modest attempts of Moldovan companies to obtain international certificates of quality. However, the certification of production processes leading to issuance of the EurepGAP certificate, respectively HACCP, are just basic conditions for accessing the market and do not guarantee an instant sales of the goods. As long as the companies from this sector are not accredited and recognised on the European markets, we should not expect miracles on behalf of the GSP+ or the Autonomous Commercial Preferences trade regime.

According to the expectations of the Ministry of Agriculture, next year the agriculture will grow by approximately 12.9%. This forecast assumes increase of the vegetal production by approximately 13.5% and of the animal production by 11.7%. Our forecasts are more sober, limited to 4.0–4.5%. The optimism of the Ministry can encourage only those persons who do not understand nature of agriculture. The reality shows that a high level of production can lead to as many damages as frost in the middle of spring. An eloquent example could be the quantity of apples stored in the

freezing facilities in Moldova and which cannot be sold due to various reasons. Day by day the production cost of each kilogramme is increasing whereas from the evolution of the demand we see that the market prices are decreasing. Despite the fact that the agriculture of Moldova has faced a ban imposed by the Russian Federation much earlier than the wine sector, the local agricultural producers have not managed to adapt to the new conditions so far. The developments in the sector will largely depend on the re-establishment of commercial relations with Russia. It is very important that the local producers diversify their sales markets and minimise the risk of repeating embargoes of 2005-2006. This, however, is to be done in a long-term perspective and without losing the previous distribution channels.

## Constructions

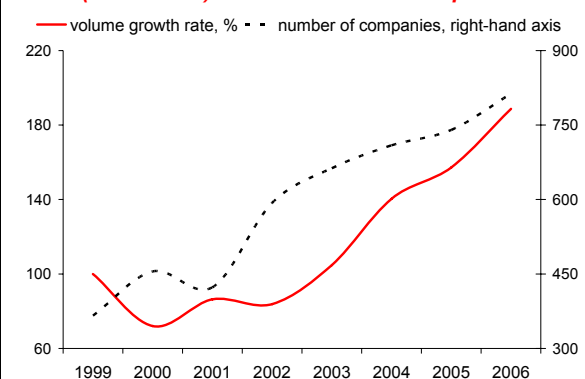
In 2006 the tendency of expansion in constructions continued for the 4<sup>th</sup> year in a row. Apparently, the year finished on an overly positive note for the construction sector, the operators reaping huge profits. The attractiveness of the sector seems to be extraordinarily high as suggested by the rapid increase of the number of operators on this market. The increase is mainly achieved by the local private enterprises at the expense of the state companies or companies with foreign capital.

Due to the favourable weather conditions, the economic activity in the sector of construction remained very intense even in December. It is not surprising that the volume of works performed in 2006 was 20% higher than in 2005 (Fig. 4). Three quarters of the construction-assembly works were performed by the enterprises from Chisinau Municipality, but a strengthening activity is being observed in other towns as well.

At the same time, the supply responds mainly to the demand for apartments from the upper price layer. Within the inferior segment of prices the supply of new apartments remains anaemic. That is the reason why the prices in the real estate sector have continued to increase practically during the whole year.<sup>1</sup> After they increased in October to 780 USD/m<sup>2</sup>, in November – December the average price was estimated at 790 USD/m<sup>2</sup>.

However, a more profound analysis shows that in the construction sector the perspectives are not that “rosy”. In 2006, for the first time in the last five years, the demand for apartments decreased significantly under the level of supply. According to some estimates, during the first nine months, the monthly supply of apartments was twice as high as the demand and this was mainly due to the decrease of speculative demand. This is the first signal that the anticipations of the companies from this sector

**Fig 4. Growth of the volume of construction-assembly works (1999=100%) and the number of companies**



Source: NBS

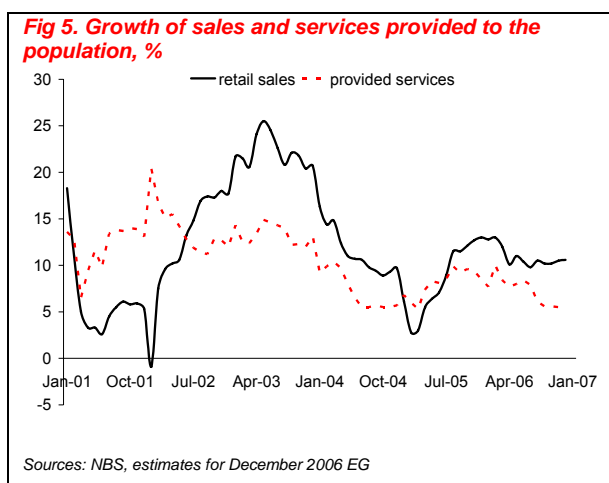
<sup>1</sup> According to the information provided by the real estate agency Lara, [www.lara.md](http://www.lara.md/?m=page&id=2), link <http://www.lara.md/?m=page&id=2>.

are probably excessively exuberant and the price reached the quotas hard to maintain. In order to avoid the overheating of the real estate market, the operators from this market will have to revise their sales techniques, to contribute to the development of the mortgages and diversify the supplies.

Taking into account the dynamic of 2001-2006, it is however hard to believe that in 2007 a dramatic decrease of prices could be possible. Rather supply of the apartments of average price (790-810 USD/m<sup>2</sup>) will grow but these will meet better conditions than before. In other words, together with the gradual saturation of the real estate market and the intensification of the competition among the construction enterprises, the market will get more mature and the consumers will receive living spaces in which they will have to invest less in order to adjust them to a living condition. One of the modifications that could lead to essential changes in the market structure is the institution of new real estate taxes. As result of their application, properties with a larger surface will reduce in price due to the “burden” of the annually paid taxes.

## Retail and services

The Moldovan citizens remained keen on the consumption despite problems in the production sector. However, a certain moderation of the consuming dispositions has been observed. According to some estimates, the services provided to the population have increased by approximately 6% and the volume of retail sales of the goods increased by approximately 8-9%, i.e. below the indexes posted in 2005 (8.5% and 13% respectively, fig 5). However, the maintenance of growing sales is to the great extent conditioned by the consumption in cities, while in the rural areas and in small towns the consumption is limited by the low revenues. In 2005 the incidence of general poverty increased significantly (from 26.5% in 2004 to 29.1% in 2005), while in the large urban zones it decreased. According to some indicators, in 2006 the incidence of poverty continued to increase, reaching about 32-33% and this is almost entirely due to the rural poverty.

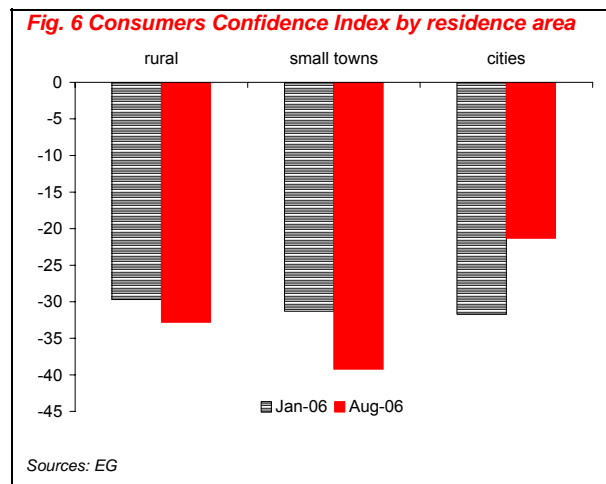


The consumption proclivity is fuelled by the payroll rises in many branches of the industry and the service sector, by the revenues of the individual business activity and the remittances by the Moldovan migrants. According to the recent data of the NBM, in Q1-Q3-2006 the labour remittances increased to 800 million USD, approximately 24% more than in 2005. This is a surprisingly high increase, though the majority of specialists considered previously that the growing potential of work remittances is almost exhausted.

The perspectives for increasing the retail sales in 2007 are rather good, although geographically limited. It seems that the retail chains have very optimistic anticipations towards the market potential. In 2006 several big retailers extended their existing

networks and two international groups declared their intentions to launch business in the retail sector in Moldova. By now the companies from this sector ignored the potential for expansion in the regions, their activity being limited to 1-2 large cities. In 2007 the competition will intensify particularly as regards small towns.

However, the positive anticipations of the companies do not fully correspond to the economic confidence of the consumers from the small towns. The Consumers Confidence Index measured by the EXPERT-GRUP in January 2006 and in August 2006 proves the most significant worsening of the economic confidence among citizens from small towns (Fig. 6). In 2006 the economic sentiment improved in two large cities, Chişinău and Bălţi<sup>2</sup>. Now we are to see if the real evolutions will introduce positive corrections in the negative perceptions of the public.



In 2006 the National Agency for Regulations in Telecommunications and Informatics (NARTI) attributed, with no tender announced, the license for mobile telephony services in the CDMA 2000 standard to the operator of fixed telephony Moldtelecom (state-owned company). In December 2006 a public tender was organised for providing the third license for rendering mobile telephony services in the GSM 900/1800 standard. The joint venture „Eventis Mobile” won the tender. Taking into account these events, in 2007 we are expecting favourable evolutions for the consumers: tariffs reduction, increased quality for the provided services and diversification of supply. The market of mobile telephony services still has unexplored potential. This fact has been proved, among others, by very high profitability indicators of the current market operators.

The year 2006 was less positive for the transport sector. The train, car, river and air transport companies conveyed 14.6 million tons of goods, a volume that is 4.4% lower as compared with 2005. According to the National Bureau of Statistics (NBS) the decrease was determined by the reduction of the volume of goods transported by train (-6.5%). The transportation of passengers has not suffered too much and this is due to the private transport operators, which were able to compensate partially the recession in the sector of goods transportation. As many as 109 million passengers were transported by buses and minibuses and 396.6 thousand passengers were transported by air in 2006. As compared to 2005, their number increased by 3.6% and 9.6% respectively.

In 2007 the demand for consumption will remain rather high, increasing by 8-10%. The sources that will ensure the purchasing power will remain the same as in 2006: the considerable increase of the salaries, the revenues derived from business and from remittances.

<sup>2</sup> For more details on the methodology and results of the Consumers Confidence Index see the EXPERT-GRUP site, link [http://www.expert-grup.org/pub/raport\\_cci\\_nr2.pdf](http://www.expert-grup.org/pub/raport_cci_nr2.pdf).

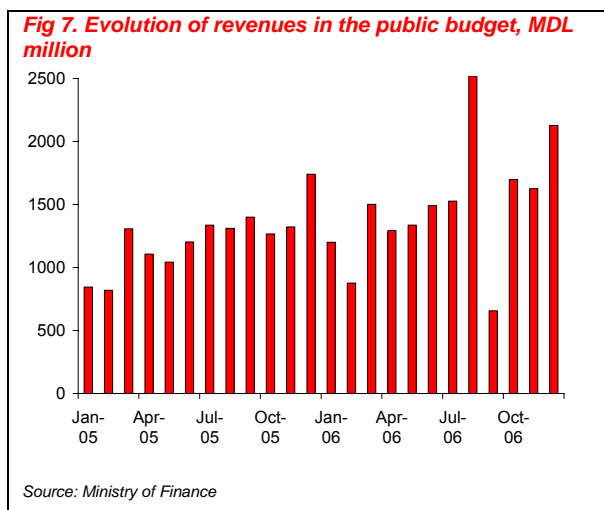


## Public finance

Despite the difficulties in the production sector related to the banned exports of wine to Russia, the public budget revenue losses were not catastrophic, being estimated at about 400 million lei<sup>3</sup>. This fact is explained by the quasi-total dependence of the budget on the indirect taxes, mainly VAT. Even though in 2006 a higher volatility of the monthly revenues than in 2005 was observed (Fig. 7), the total public revenues were collected in proportion of 101.7% from the planned level and by 22.9% more than in 2005. According to the updated information<sup>4</sup>, the essential negative deviations from the planned level were in collecting the revenues from the state social insurance contributions (-38 million MDL, determined by the lack of appropriate fiscal constraints against non-restructured state-owned enterprises and the reduction of salaries in the wine-making sector), from the land tax (-13,5 million MDL, determined by the poor condition of the agricultural sector) and from the special means collected by central and local public institutions (-24 million MDL). In the latter case, it seems that there is a link between the decrease of revenues and the implementation of the regulatory reform, but this topic requires further research.

As shown in the previous monthly editions, the management of budgetary expenditures in 2006 was very poor. We should primarily mention the fact that the annual expenditures have been financed at the level of 97% of the planned one (17,978 billion relative to 18,534 billion). In the case of such important sectors as education and agriculture, the expenditures were 145 million and 51 million lower than planned.

Secondly, according to the official information during the first 11 months of the year the expenditures have been executed at the level of only 87.5% of the plan for January-November 2006<sup>5</sup>. In other words, in order to execute the expenditure as close to the planned level as possible, during the last month of 2006 the budget executors of the public authorities and institutions of different levels spent about 3 billion MDL, as compared with the monthly average of 1.4 billion MDL spent during the first 11 months! No special efforts are necessary to understand how “efficiently” this public money was spent. More details regarding the minimal efficiency and transparency in using public money see in the box 1.



<sup>3</sup> Interview of the Minister of Finance Mihai Pop offered to the Basa-press news agency.

<sup>4</sup>

[http://www.minfin.md/common/nationalbuget/operativinfo/decembrie\\_2006\\_II/1Informatia\\_operativa\\_privind\\_executarea\\_bugetului\\_public\\_national.pdf](http://www.minfin.md/common/nationalbuget/operativinfo/decembrie_2006_II/1Informatia_operativa_privind_executarea_bugetului_public_national.pdf).

<sup>5</sup>

[http://www.minfin.md/common/nationalbuget/operativinfo/noiembrie\\_2006/1Informatia\\_operativa\\_privind\\_executarea\\_bugetului\\_public\\_national.pdf](http://www.minfin.md/common/nationalbuget/operativinfo/noiembrie_2006/1Informatia_operativa_privind_executarea_bugetului_public_national.pdf).

In November 2006 the Parliament of the Republic of Moldova adopted in the final reading the law on state budget for the year 2007. The parameters of the budget were determined based on the following macroeconomic assumptions: the GDP growth rate in 2007 will be 4%, the average annual exchange rate – 14.6 lei/USD, the inflation rate will be under 10.5%, the internal public debt – 3,899 million lei, the external debt administered by the Government – 728 million USD. The total revenues in the state budget will be 12,088 billion lei and the expenditures – 12,161 billion, with a deficit of 73 million lei. The deficit estimated at 0.7% of the GDP is not likely to create any macroeconomic problems as long as monetary stability is ensured and no new trade shocks emerge.

#### **Box 1. Examples of deficient use of public funds in 2006**

The year 2006 is very illustrative as regards the lack of transparency and correctness in use of public finance. Practices of offering fiscal facilities, exemptions and direct subsidies to the companies continued with no transparency or limits on use of subsidies imposed. The Parliament repeatedly approved fiscal derogations, exemptions and other unwarranted disbursements. The most concluding example is the provision of 583 thousand lei to the Public Company Teleradio-Moldova from the Government reserve fund for covering the debts owed to the national public budget! Such “fiscal practices” are hard to explain from the economic point of view.

On 26 October 2006 the Parliament adopted a law in order to improve the economic-financial situation of the State Enterprise „Moldtranselectro”. The law annuls the penalties and the fines accrued for the enterprise fiscal debts. It is a matter of an amount of 218 million lei. This fact highlights the lack of any understanding on behalf of the lawmakers as regards the functioning of the enterprises under market conditions and creates fiscal indiscipline in the entire public sector of the economy.

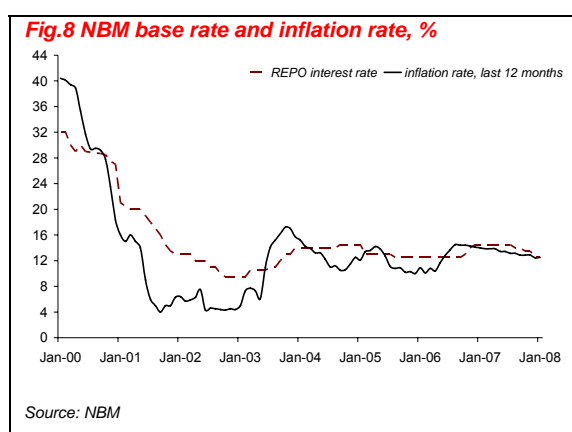
The State Council of Creditors continued the procedures of “fiscal isolation” of some enterprises with state or predominantly state capital. In most cases, these decisions had only a limited impact on the financial situation of the given company, without improving significantly the long-term managerial performances. Transparency of the state control over public finance management was not ensured. For instance, the Audit Office did not publish integrally the results of the financial revision carried out at the Centre for Prevention of Economic Crimes and Corruption for 2003 – 2004. The ‘state secret’ explanation invoked by the Audit Office is “nebulous” at best.

In November the Parliament approved the provision from the state budget of 93 million lei to the State Company “Air - Moldova” for purchasing an aircraft. The “transaction” is dubious for many reasons. Firstly, the aircraft is to be purchased by means of a network of companies registered in the offshore. Secondly, the provision of such an amount was done at the expense of other priorities, especially those from the social sector. Finally, this form of support of a company with a commercial purpose distorts the free competition and stimulates even more the budgetary indiscipline of the companies with state capital.



The monetary policy of the National Bank of Moldova (NBM) suffered essential changes in 2006. The effects of these changes are to be felt entirely in 2007. In June 2006 the Law on the NBM was amended. In its current version, the law stipulates a greater institutional independence of the Bank, establishes the inflation control as main objective of the NBM and eliminates the possibility to credit the state by the Bank, inclusively by acquiring state securities on the primary market (for more details see box 2). Previously, even though the law would not allow the direct financing of the budgetary deficit, a hidden financing by purchasing the securities issued by the Ministry of Finance was possible.

The legal ban on financing the budgetary deficit by monetary means is a sign of more mature economic thinking that will boost development of the financial market in Moldova. At the same time, this positive development stems, to a great extent, from the obligations assumed by the Government and the NBM within the Memorandum on Economic and Financial Policies signed with the IMF in 2006. The signing of this memorandum is, in our opinion, the most important economic event of 2006.



In the 2<sup>nd</sup> half of the year, the legislative amendments were followed by the much more restrictive monetary policy by the NBM aimed at fighting the inflation risks that have escalated starting May 2006. Since the control over the inflation was declared the chief objective of the NBM, the role of open market operations as tools of the monetary policy increased and that of currency interventions declined. The macroeconomic stabilisation and the economic growth in the following years will crucially depend on the accomplishment of the anti-inflationary target. In order to achieve the fundamental objective, the intermediate objective pursued by the NBM is the rate of increase of money supply and the operational objective is the monetary base. Nevertheless, the task of NBM is an extremely difficult one due to the constant inflows of foreign currency. In order to control efficiently the inflation, the NBM is to diversify its portfolio of monetary policy tools.

If in April 2006 the annualised rate of inflation was of 10.4%, then in August the indicator exceeded 14.5%. Within a highly inflationary environment, on September 28, the NBM was forced to increase the basic rate of interest (REPO) from 12.5% to 13% annually, on 16 September the rate increased to 14% and on 1 December – to 14.5%, returning to the level of December 2004 (Fig. 8). The pursued purpose was to sterilise excessive liquidity on the market.

If no external shocks are produced, the increase of the main rate of the NBM will lead during 2007 to a certain moderation of inflation. The monetary history of this decade shows that inflation is rather sensitive to the variations of REPO rate. By December 2007 the annualised rate of inflation will decrease to 12.5 – 12.7%, which will allow the main rate of the NBM to return to the level of 12.5% reached in 2005. However, the “magical” target of inflation of 10% will most probably not be reached.

Why should the reduction of inflation be the main objective of the NBM? Since a high double-digit inflation has serious systemic effects. Due to the inflation expectations, the commercial banks increase the bank deposit rate, which leads to the decrease of the inclination for investments. The inflation reduces private welfare, especially as a result of fixed revenue erosion. Inflation raises pressures on the budget, since the necessities for financing the social assistance policy increase as well. At the same time, the NBM is to endorse entirely the objectives it sets and not to intervene with amendments that undermine the public trust towards its policy. Such an example was the urgent modification in December 2006 of the monetary policy for 2006 by which the provisions of the document were adjusted to the macroeconomic realities.

## **Box 2. Legislative modifications and the monetary policy of the NBM**

The Law on the NBM was amended in 2006<sup>6</sup>, the most important modification being the specification of the main objective of the Bank. (Another legislative amendment from November 2006 also modifies the way of forming the NBM capital). In the previous version, the objective of “reaching and maintaining the stability of the national currency” left space for ambiguous interpretation as it was not clear whether the NBM should chiefly orient to the internal stability (control over inflation) or towards the external stability (control over exchange rate) of the Moldovan currency. Since the circulation of the international capital in Moldova is liberalised, it was rather problematic for the NBM to combine the two objectives mentioned above. The National Bank does not possess currency reserves that would ensure capacities of effective intervention on the monetary market. Currently, the Law stipulates clearly that the fundamental objective of the NBM is “ensuring and maintaining the price stability”. In a long-term perspective, this is the best solution for tempering the inflationary anticipations and increasing the public confidence towards the anti-inflationary commitments of the NBM and will allow the NBM to accumulate larger currency reserves.

By the June 2006 amendments, state crediting by the National Bank is prohibited. In its new edition, Article 41 of the Law on the NBM bans expressly the provision of any loans and financial collateral to the Government, inclusively by purchasing state securities on the primary market. (Re-arrangement of loans provided earlier to the Government by the NBM could be carried out by derogation from this provision. It is a significant derogation if taking into account the fact that the internal state debt contracted from the NBM is over 2.5 billion lei).

Article 12 that stipulated “collaboration” of the NBM with the Government in establishing and promoting its monetary and exchange-rate policy was also eliminated from the law. Moreover, from now on any draft of normative act issued by the public authorities on the areas where the NBM has any attributions will be adopted only after the approval of the National Bank. These provisions significantly enhance the independence and institutional authority of the Bank. On the other hand, the legislative amendments eliminated the immunity of the NBM governor and introduced the provision that the administrative board members of the NBM can be seized, arrested or called to criminal or administrative account only

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<sup>6</sup> Law no. 191 from 06/06/2006 on the amendment and completion of the Law no. 548-XIII from 21 July 1995 on the National Bank of Moldova.

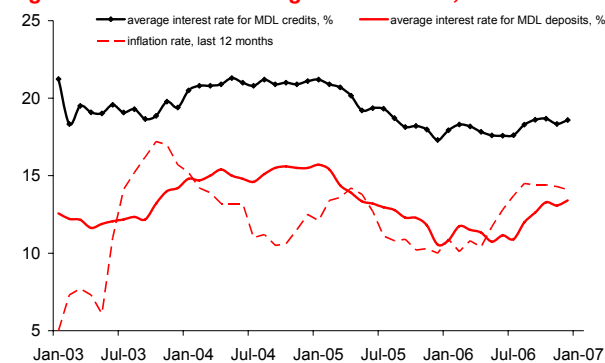
according to the decision of the general prosecutor. Now we should expect to see the combined effect of these amendments on the real independence of the NBM.

## Banking system

In 2006 the bank system development was marked by several significant events. Among the most important evolutions we would like to highlight the entrance of foreign investors on the banking market. They either overtook the integral, controlling, blocking, or investment interest of the local banks or opened their offices in Moldova. Thus, ExImBank was overtaken by the Italian group Gruppo Veneto Banca, and the Austrian group Raiffeisen International opened its office by means of its subsidiary from Romania. The entrance of the Societe Generale through the Mobiasbanca is also a 2007 evolution, even while only in January 2007 the event took place effectively. We cannot omit the announcement made by the new shareholder of BCR, Erste Bank, to extend the activity of the BCR Chisinau subsidiary. Another important event was the withdrawal by the NBM of the authorisation of Businessbank SA to perform financial activities. All these events have intensified the activity of the banking system as a whole, the following years being decisive for the qualitative leap that has been so much expected by the business community as regards the functioning of the banking system.

Analysing the bank interests in 2006, one can observe that the average rate of interest on the deposits in foreign currency remained in fact at the level of 2005, 5.17%. The biggest modification occurred in the average rate of interest on the deposits in MDL that decreased to 11.93% comparing to 12.99% in 2005. This decrease is mainly due to May-August when the interest decreased even lower than 11% (fig 9). Such a situation took place only in December 2005 (10.55%) and January 2006 (10.83%). Despite the rumours regarding the depreciation of national currency due to the increase of prices on energy resources were insistently circulated and the population confidence in the national currency was fading, the commercial banks did not hurry to raise the rate of interest on deposits. Taking into account inflation for the last 12 months, interest for deposits turned negative in real terms. This trend held for the rest of the year. Just in August 2006 interest for deposits in MDL started growing, reaching 13.4% in December. During this period banks started to show more creativeness in promotion of bank deposits and, particularly, of those in domestic currency, launching various promotions and special offers. Probably, commercial banks revised their policies after analysing situation in April-June. During this period despite falling interest for deposits in foreign currency, their attractiveness for population grew and, as a result, several banks felt deficit of available liquidity for credits in leu. Other concerns for the banks stem from the import interdiction imposed on Moldovan wines exported to Russia, and probably, from entrance of new competitors with new ideas and resources.

**Fig.9 Evolution of the average interest rates, %**



Sources: NBM

In 2006 interest for leu-denominated credits periodically showed tendency towards decreases. Average interest fell from 18.93% in 2005 to 18.18% in 2006. To a large extent, this can be explained by growing demand for consumption credits and mortgages as well as by heightening competition on this segment of market, eyed by new comers. However, the leu-denominated credits' interests started growing in August and this should not be neglected. This trend was supported by expensiveness of resources attracted as bank deposits and inter-bank loans. As in the case of deposits in foreign currency, interest on foreign currency denominated credits barely changed from 11.07% in 2005 to 11.06% in 2006.

Last year was also marked by a couple of corporative scandals that unfavourably influenced public image of some commercial banks. These scandals also bore some pronounced political traces. Practice shows that political interference in economic realm usually ends up with worsening management, diminishing transparency and undermined business culture in a country.

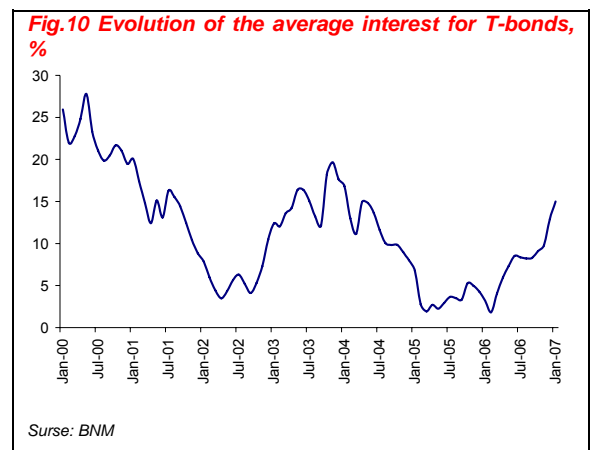
Obviously, next year will be marked by heightened competition as even more new players may enter the market. New rules will be shaped not only from the inside of the banking system, but also from abroad. Amongst the most important trends that will influence development of the banking system will be energy and economic dependence, Transnistrian conflict, enlargement of the EU up to Moldovan borders and significant changes in emphases in monetary policy of NBM.

## Financial markets

The treasury bonds market in 2006 was significantly affected by the processes occurring in the real and bank sectors. It is in 2006, more exactly in February, when the interest rate has reached record lows, only 1.83% (fig.10).

The interest rate reached its maximum of 12.9% in December. This trend continued in January 2007 (reaching 15%) and will probably persist in the next months. The upward path of the interest rate in March-December 2006 hinges on several factors: acceleration of the price rise, increasing interest for the inter-bank credit and reduction of disposable liquidities in the banking sector. The average nominal interest rate for the T-bonds traded on the primary market in 2006 increased to 7.34% compared to 3.66% in 2005, reversing the last year's decreasing trend.

The tendencies on the currency market divide year 2006 into two periods (fig.11). In January-August Moldovan leu continued its slide against the US dollar since the beginning of September 2005 level of 12.57 MDL/USD. In 2006 it decreased from 12.85 in January to 13.33 MDL/USD in August. This dynamics was determined by both speculative and fundamental factors.



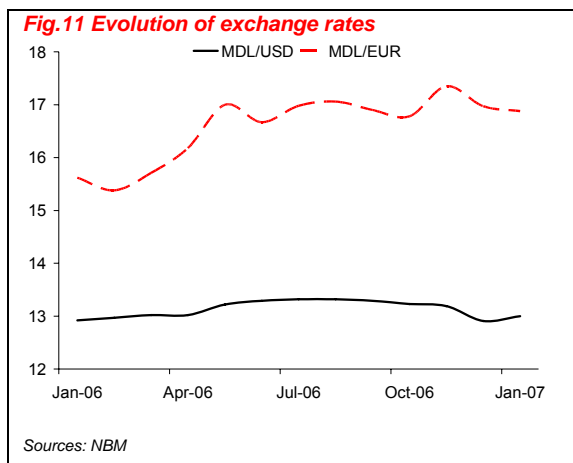
The fundamentals were chiefly supported by the demand (the dramatic increase in the imports value, as a consequence of rising energy prices in the global market and for the energy imports from the Russian Federation), as well as by the developments on the supply side (the decrease of exports income in the wake of the embargo imposed on Moldovan wines by the Russian Federation). The decrease of the foreign currency supply in January-August was also determined by a significant growth, at a 39.5% rate, of the bank deposits in foreign currency. The deficit of export incomes was compensated, to a certain degree, by

the remittances from abroad sent by the labour emigrants. During this period NBM considerably decreased its interventions on the currency market. If in January-August 2005 NBM purchased foreign currency valued 149 million USD, then in January-August 2006 the volume diminished to mere 19 million USD.

The second period – September-December – was characterized by the leu appreciation against the US dollar, the average rate in December rising to 12.905 MDL/USD. This dynamics was influenced by a greater inflow of dollars and euros from individuals, a certain intensification of exports to western markets and a deficit of national currency in the banks. The decreasing rate of the leu in comparison with the European currency (15.62 MDL/EUR in January and 17.35 in November 2006) basically mirrored the dollar-euro evolution on the international markets. Starting a local minimum of 1.1848 USD/euro in January 2006, the European currency appreciated to the ratio 1.3339 by December 14, 2006.

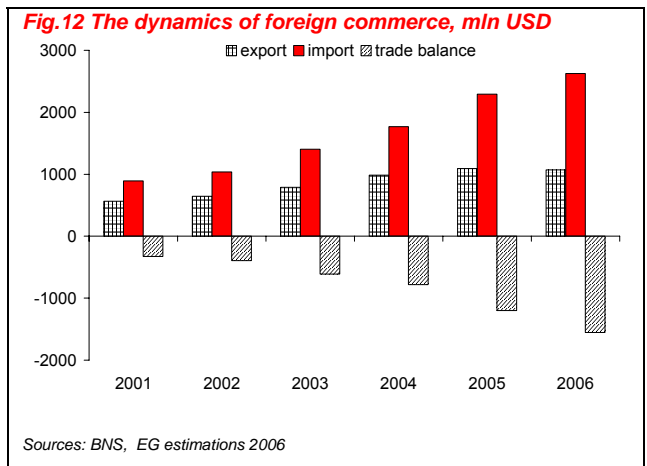
In 2006 a certain improvement in the life insurance sector took place, thus still more significant developments are expected in 2007. An important event was the take-over of the Donaris Life Insurance company by the Austrian Grawe group. In 2007 we expect the number of efficient local companies to increase at the expense of inefficient ones due to the opening of new divisions in Moldova by Romania-based international operators.

As far as the capital market is concerned the 2006 results are mixed. The Moldovan Stock Market showed a rise in numbers of the transactions and increase in capitalization. However, these tendencies were mostly determined by few unrelated transactions, concerning mainly bank securities, and not by a quality or systemic development of the local capital market.



## Foreign trade

In 2006 the foreign trade underwent contradictory evolutions, however the adverse ones prevailed. On one hand, the embargo imposed on the import of Moldovan wine by Russian authorities had a serious effect on the wine-making industry and main Moldovan exports. According to the data for January-November 2006 the exports to the CIS decreased by 23.5%, especially due to a ruinous reduction of exports to Russia (-47.3%). The impact of this decrease was somehow softened by the increase of exports to Ukraine (+27.1%). The latter would have been larger if in April 2006 Kiev hadn't banned the imports of meat and meat products from Moldova.



The commercial difficulties from the east didn't stop there. During the last year Gazprom raised the prices for gas in two stages, from 80 dollars to 160 USD/m<sup>3</sup>. Combined with high prices at the global energy markets these developments determined an increase in the value of the imports. As a result the trade deficit soared (fig.12).

On the other hand, the 'commercial breeze' from west did not have the desired soothing effect. The granting by the EU of trade preferences within the GSP+ framework, followed by Moldova's accession to the CEFTA, has not yet brought the expected outcomes. Exports to European Union slightly grew in the second half of the year (+11.2%). Ultimately, the companies themselves are to be blamed for the performances below expectations, since they have been unable to benefit from the new opportunities, mainly due to low quality of the products.

The exports to Central and Eastern European countries grew much stronger (+39.2%). The exports grew most of all to Romania (33.8%) and Bulgaria (exports increasing 1,9 times).

Overall, annual exports are valued at approximately 1071 million USD, a decrease of 2.0% against previous year. The value of imports rose by 13.6% to 2326 million USD. This resulted in deterioration of the trade balance of Moldova. The deficit sank deeply in red to 1555 million USD.

The slow increase of the exports reveals both the vulnerability of Moldovan economy when facing "external shocks" and the extremely low competitiveness of Moldovan goods, which amplifies this vulnerability even more. At the same time, if the authorities concentrate their efforts on the elaboration of strategies for "internal use", without implementing any practical measure that would stimulate the exports, it is unlikely that the serious troubles that are faced by our foreign trade would be solved by themselves. One of these practical measures would be adopting international quality standards (but not by establishing state monopolies that would be corruption-prone) and imposing more transparent customs procedures. So far, as it can be seen in its own public



reports, the customs office evaluates the efficiency of its activity, only by the amount of the taxes collected and not by the degree it facilitated foreign trade<sup>7</sup>.

In 2007 the problems of the previous year will not simply disappear. A real re-launching of the wine exports to Russia represents a cumbersome technical process. Its benefits will not be spread among all the wine producers from Moldova. Moreover, the Moldovan winemakers will find many market niches occupied and will not be able to recover its hold on the Russian wine market. The energy market will remain tight, whereas the prices for gas will probably follow the same ascendant trend. Not even granting of Autonomous Commercial Preferences by the European Union would be a cure for all. So, Moldovan products will need to undergo an important quality improvement to make use of these preferences. In a short term perspective, Romania and Bulgaria's EU accession and consecutive dismantlement of free trade agreement with these countries will certainly have a negative impact on some of the Moldovan exports to the above-mentioned countries. Thus, in 2007, the trade deficit may well witness new dizzying lows.

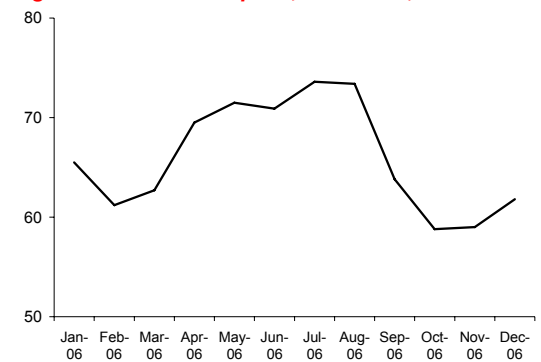
## Global oil market

In the first half of 2006 the oil prices continued to grow. The interplay of several factors determined the high prices: 1) a significant rise in demand (+1.1%<sup>8</sup>) in China and India; 2) geopolitical instability in the Middle East (the conflict in Lebanon, security risks linked with the Iranian nuclear dossier); 3) a serious decrease of oil production in Nigeria (-20%). The oil price reached its apex of 78.4 USD/barrel (WTI brand) on July 14, 2006.

However, this trend reversed in August, when the geopolitical risks receded as well. The Lebanon conflict had ended and it had become clear that military operations are not possible in Iran in short-term. Unusually favourable weather conditions (an extremely calm hurricane season in Gulf of Mexico) and diminishing demand from China exercised downwards pressure on prices too. The price for oil began rising only towards the end of November, slightly exceeding 60 USD. This tendency was firmly supported by the decision of OPEC Council to reduce the volume of extracted oil and by the announcement of tentative reductions in February 2007.

The majority of the oil market seers are expecting the "expensive" (with certain fluctuations) oil trend to persist at the level of 60-65 USD/barrel in a short term perspective. As far as it concerns the medium and long term ones, there is no agreement among the pundits. Forecasts vary from "cheaper" oil at the end of 2007

**Fig.13 Evolution of oil price, WTI brand, USD/barrel**



Sources: EG calculations based on the data provided by The Economist

<sup>7</sup> See, for instance, the publication „Curierul Vama”, January 1<sup>st</sup> 2007, nr.1-2 (63-64).

<sup>8</sup> According to the International Energy Agency.

(45-47 USD/barrel), to the possible persistence of current prices for 2 more years, with a subsequent gradual decrease<sup>9</sup>.

## **Global wheat market**

In what concerns the world wheat market, the year 2006 has been an outstanding one, firstly, due to the lowest final stocks in the last 25 years. The diminishing supply and growing demand fuelled this evolution. At the same time, there has been a rise in supply, towards the end of the year. This is mostly due to production increase in Europe: Russia (+1.4 million tons) and EU-25 (+0.7 million tons). On the whole, during the agricultural year 2006-07 the world final stocks have increased by 1.1 million tons reaching 121.8 million tons. Still, not even this increase would significantly raise the stocks from the lowest level reached since 1981/82<sup>10</sup>. As a conclusion, we may expect that in the nearest future the tendencies of the rising prices would persist, favouring Moldovan wheat farmers.

## **Trade partners**

During 2006 the evolution of the economies of the main trade partners was favourable for the expansion of Moldovan exports. However, to benefit from these positive tendencies, to overcome the non-tariff barriers and to improve the competitiveness of Moldovan products it was necessary to apply more serious efforts, by authorities and manufacturers.

Russian economy enjoyed a healthy growth throughout the year. According to preliminary estimates the growth rate reached 7% in 2006, as compared to 6.4% in 2005. This increase was supported by: 1) a strong rise in the consumption, reinforced by increasing real available income of the population (+10.1%, January-November 2006); 2) increase in investments (+12.9%) and 3) expansion of exports (+25.4%, with a certain deceleration in September-October). Russian experts expect positive effects of consumption and investment demand to persist in short-term perspective.

As far as it concerns GDP increase, the greatest contributions came from trade (+12.8%) and construction (+14.2%). Among other Russian economic successes we may list inflation under 10% and a considerable growth of currency reserves, which reached 295.8 billion USD.

Notwithstanding these successes, year 2007 will bring several important risks for the Russian economy. It is mainly the strengthening inflationist pressures and a decrease of investment activity and consumption demand, phenomena that were mainly based on the rising of oil and metals prices on the international market. Taking into account the change of prices on these markets, the economy will be forced to rely increasingly on

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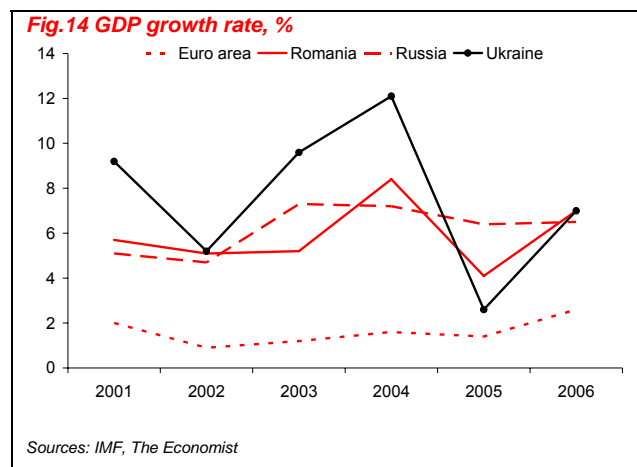
<sup>9</sup> Sources: The Economist, BusinessWeek, Global Insight Inc., International Energy Agency Oil Market Report, International Monetary Fund, Kommersant.

<sup>10</sup> Sources: USDA, World Agricultural Supply and Demand Estimates, Wheat Outlook.



other sources of growth. Still, the majority of experts are optimistic as far as it concerns Russian economic perspectives, forecasting a 6% increase in 2007<sup>11</sup>.

Year of 2006 turned out to be year of economic rebound for Ukraine. After a feeble growth in 2005 (2.6%), the increase rate was much more impressive in 2006 (7%). This happened despite the tensions between the President and the Cabinet and the fierce struggle between the parliamentary majority and opposition. Favourable situation on markets of main Ukrainian exports (metals) allowed soothing the effects of the price increase for the imported gas.



The economic growth was firmly supported by the expansion of investments (+11%, after they decreased by 0.3% in 2005). The surge in investments is both the result of the increasing public investments, as well as a response to the burgeoning internal consumption demand. The latter increased by 18.6%, also due to a real rise of the average salary by 19.1%. The expansion of consumption, combined with the increase of gas prices, led to worsening of trade balance, the commercial deficit reached -3.2 billion USD or 3.1% of GDP. And still this does not endanger the stability of the national currency, the Central Bank having vast monetary reserves and promoting a cautious monetary policy.

The economic prospects for the next year are relatively rosy and the majority of experts forecast a 5-6% increase next year. The role of the investments will strengthen, including those in the energy-saving technologies, whereas the private consumption will see a weaker growth. An unfavourable change on the metals markets will increase the trade deficit. Political uncertainties will continue to detract from a potential economic growth<sup>12</sup>.

The economic growth estimated in the EU countries (3%) was more significant than it was previously forecasted. The increase in the euro zone was, however, less impressive - 2%<sup>13</sup>. The exports (increased by 12%) and investments (+4.6%) which fuelled the growth, however the intensification of private consumption played an important role as well. This economic rise also fuels growth in retailing. Retail in “food, drinks and tobacco” in the euro zone and EU has increased by 0.3% and 0.9%, respectively. The most important growth is witnessed in the Baltic and the Visegrad group countries. Geographic proximity to the zone is one of the advantages for producers from Moldova.

<sup>11</sup> Sources: Ministry of Economic Development and Trade from Russia, Federal Statistics Service, The Economist, BusinessWeek, International Monetary Fund.

<sup>12</sup> State Statistics Committee from Ukraine, International Centre of Political Studies (Kiev, Ukraine), International Monetary Fund, The Economist.

<sup>13</sup> <http://www.ecb.eu/stats/keyind/html/sdds.en.html>.

In November 2006 the industrial production in EU was 2.5% higher than in November 2005, and in the euro zone – by 2.9%. The industrial growth in Germany (+5.6%) and Italy (+2.2%) is particularly remarkable. Unemployment in EU, decreasing throughout the year, has reached 7.7% in November 2006, compared to 8.6% in November 2005.

All forecasts predict that European economy will maintain this ascending trend. The majority of the analysts expect it to grow by 2.0-2.5%, supported by the consolidation of consumption demand. Furthermore, the role of EU economy in the global economic growth will strengthen comparative to that of United States and Japan, where the growth will weaken somewhat.

Last year was characterized by a significant economic growth in Romania as well. It was estimated at 7%. According to November 2006 data, the growth is attested in all sectors of economy: in construction (+21.2%), services (+27.9%), and industry (+7.4%). Industry shows a certain slowing of growth, which is caused by insufficient demand. The consolidation of economic activity was reflected in the decrease of unemployment rate from 5.7% in November 2005 to 5.1% in November 2006.

Positive evolution was seen in retail, including food, drinks and tobacco, the volume of sales growing by 24.6%. The final household consumption expanded by 12% due to the consolidation of real salaries in economy (+12.1% in November 2006, compared to the same period in 2005). During the first 11 months of 2006, the trade balance deteriorated by 42.2% compared to the same period in 2005 due to the rise of imports (24.5%) and diminishing growth of exports (16.7%). The surveys of economic confidence for November 2006-January 2007 forecast the maintaining of the rising tendency of production volume in industry, retail, services and a slight decrease in construction.

The forecasts of economic growth in 2007 converge towards 6%. At the same time, year 2007 might present some risks that could restrain the growth. These risks include an increasing tension within the government coalition, the limited capacity to absorb European funds after EU accession in January 2007, reduced competitiveness on the European market and current account deficit.<sup>14</sup>

Despite these risks, Romania's joining the EU creates positive economic effects for Moldova that can be capitalized in the long term. Among these are: convergence of prices in Romania towards a European average mark, an increase of labour demand on the Romanian market and possible migration of certain manufacturing capacities from Romania to Moldova, to explore the advantages in manufacturing costs.

## Prices

After a relative slow-down of inflation rate in 2004-2005, in 2006 the inflationist pressures augmented again. Throughout the year, the Consumption Price Index (CPI) increased by 14.1%, compared to 10.0% in 2005, and 12.5% in 2004.

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<sup>14</sup> Sources: National Statistics Institute, International Monetary Fund, CreditAnstalt Bank, Saptamîna Financiară, The Economist.

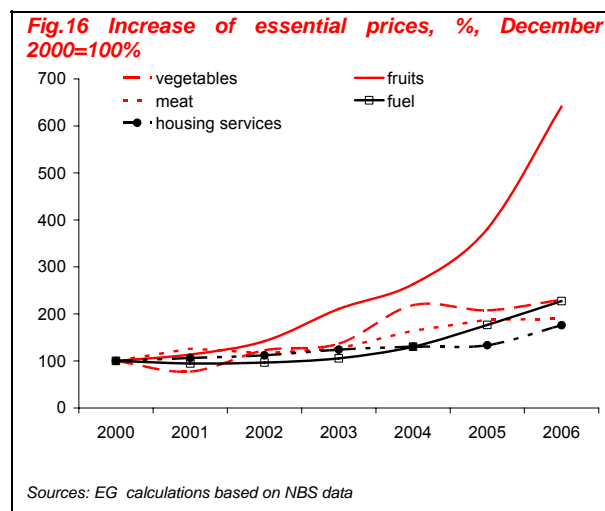
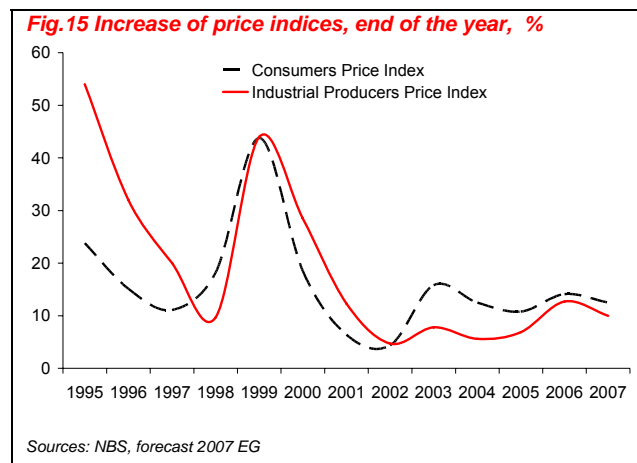
If in January-April 2006 the annualised inflation rate varied within 10.1-10.9%, then in May-August it accelerated to 11.7% - 14.5%. Afterwards it decelerated slowly until the end of the year, however avoiding sinking below 14%. The industrial manufacturers' price index reached 12.7% - the highest level during 2001-2006. The increase of industrial prices is mainly determined by the rising prices for imported raw materials and domestic/external transportation services. A significant rise of the manufacturers' prices obviously raised consumption prices.

Inflation is also, to a certain degree, the result of the expansion of demand stemming from business and consumption credits. Income tax reduction seems not to have had any effect on consumption, because it referred only the tax rates for population with low incomes.

Most of the factors that determined the rising prices in 2006 have administrative nature. For instance, the price for the gas increased twice in a row, in February and July 2006. It was, correspondingly, an administrative step to raise the fees in the urban and interurban transport. The elimination of administrative and seasonal factors would result in a lower inflation index, which would better characterize the monetary nature of this phenomenon. It would be natural for NBM in 2007 to start using such an index.

The rise in the prices for public utilities by 32% had the greatest influence upon the increase of CPI. This rise is explained by the fee rise for gas and water supply. The fuel, which has an important share in the calculation of the CPI, became more expensive by 29%. These were the main effects of the price rise for oil products on the global markets and for the gas imported from the Russian Federation. At the same time the hikes in gas price reduced demand for it, especially in the rural area. The prices for medicines also grew by 29% - another important component of CPI. It was mainly determined by the introduction of 8% VAT for the import and sale of medicines and by imposing new compulsory automated medicine labelling and registration system. Another explanation is the increase of medicine demand from medical institutions, demand, which constantly increased after the implementation of compulsory health insurance systems.

In what concerns basic foods, last year prices for fruits rose the most (68.3%), while for vegetables and dairy products they increased "only" by 11%. Potatoes' price increased by 3.2%, whereas the meat price barely changed. The fruit price rise may be



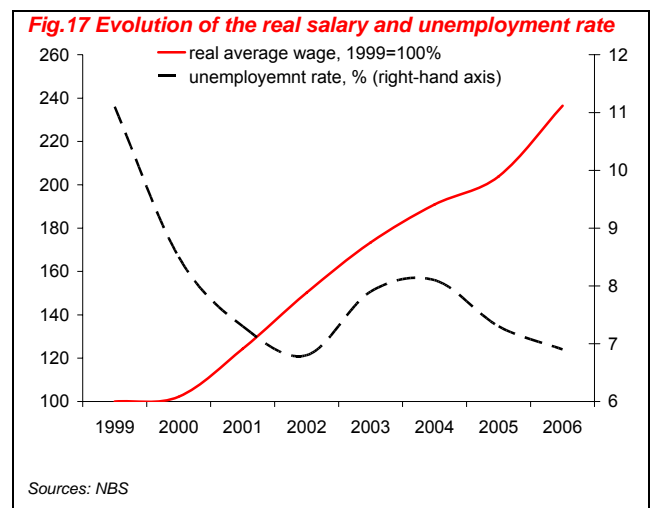
explained by the fact that they are imported and by the convergence of internal prices towards the regional ones, as well as some speculative actions of local manufacturers. This tendency will hold for a while: if we compare the prices in 2000 and 2006, the fruits are almost 6 times more expensive, whereas vegetables only 2 times.

In the future, the inflation will be determined by the interplay of certain factors with contradictory effects. The high inflation in 2006 is in itself an inflationary factor, which will keep on in 2007 contributing to inflationist anticipations. The rise of salaries and remittances will encourage inflation through consumer demand. Also, new price hikes for gas and electricity can also be expected. On January 25, 2007 the Chisinau City Hall approved the doubling of prices for heating (from 233 to 540 lei/Gcal) and for water. Half of the price will be compensated from the municipal budget. But after the general local elections the consumers will probably have to pay the entire new price. The intensification of competition in the banking sector will result in the gradual diminishment of interest rates, and this will increase the demand for consumption credits even more.

One of the factors that could halt the inflation a little might be the electoral campaign in the first half of 2007. It is very unlikely that any administrative decisions that would affect the price rise would be taken during this period. The intensification of NBM's anti-inflationist policy will bring certain results only in the long run, because too many factors with influence over inflation are now outside NBM's control.

## Labour market

In 2006 the National Bureau of Statistics (NBS) implemented a new poll sample in order to perform the Labour Survey, and modified the definition for the basic categories: employed population, unemployed population and inactive population. Consequently, such an important index as the unemployment rate is no longer comparable with the statistic data of 1998-2005. It is difficult to highlight several positive connections between the economic development and the employment of the labour force, but the active emigration of citizens to work abroad makes this practice not quite relevant. Taking the quarterly unemployment rates announced by NBS for 2006 (6.4% in Q2-06 and 5.4% in Q3-06) and the seasonal tendencies of unemployment, for the last year we may estimate an unemployment rate of 6.8-7.0%, which, again, is not quite relevant for description of the dysfunctions of the local labour market.



But even if we take into account methodology changes, it is difficult to explain the variations of certain indices. It is especially difficult to understand the 'supposed' decrease in the number of people who emigrated to work abroad. If in Q3-05 this number was estimated by NBS as 420 thousand, then in Q3-06 this number dropped to 320 thousand. It is a tremendous decrease, which is not reflected in a corresponding

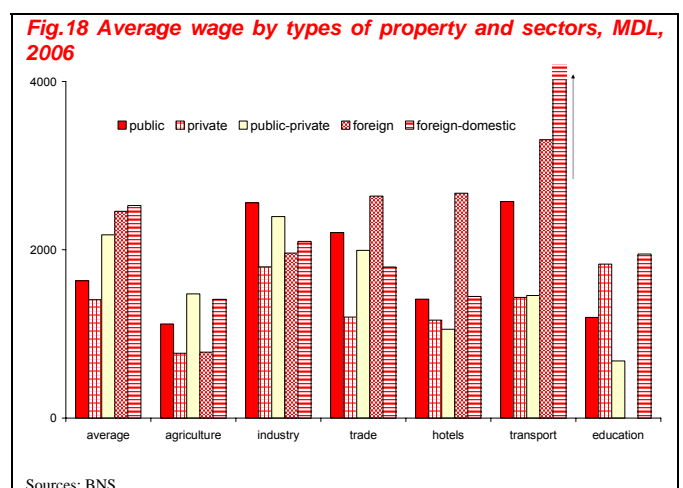
rise of the economically active population (which according to NSD increased only by 32 thousand). It is reasonable to expect that the ex-emigrants would be particularly active, from the economic point of view. That's why the return of 100 thousand citizens should have been reflected in a greater increase of employment activities (which increased only by 40 thousand), or in an increase of the unemployed (which on the contrary decreased by 17 thousand). An unorthodox explanation would be as follows: entire families left abroad and so there's no one to report about their leave. The analysis of tourist flow data, field observations and press articles suggests that the bulk of emigrants had no way to diminish in 2005-2006. These conclusions make us doubt the quality of statistic data concerning the number of emigrants from Moldova<sup>15</sup>.

The economic year 2006 started with an average salary of 1424 lei in January (110 USD) and ended, according to our estimations, with an average salary of 2175 lei (168 USD). The average salary paid in 2006 was about 1900 lei. The comparison with the previous years, shows that the average salary in 2006 increased quickly (15.5%, compared to 6.8% in 2005 and 15.4% in 2004, see fig.17) despite the economic difficulties and external shocks. This progress is explained by two categories of factors:

- The increase in the salaries in the economically efficient and expanding sectors (construction, financial services, retailing); the rise of labour pay in these sectors is determined by the accumulation of some improvements in labour productivity;
- The administrative rise of the budgetary salaries, without a spectacular labour productivity; it especially concerns the public officers' and high public officers' salaries – ministers, members of parliament (during November 2005 – November 2006 the employees in the public administration sphere enjoyed the greatest payrise, about 50% in real terms).

A real decrease in the salary was seen in agriculture (-2.4%), food (-1%) and beverages (-11%) industries, and transports (-2.6%). These were the sectors that suffered the most from the external trade shocks and internal economic dysfunctions. Agriculture and food industry also experienced a serious labour shedding (estimated by 3% and 8%).

It is worth noting that the smallest salaries are reported in the enterprises with local private capital (fig.18). From this point of view these seem even less efficient than the state enterprises in the same branches of activities. But the efficiency ratio would change significantly if the fact that the private sector widely practices labour pay “in



<sup>15</sup> Another possible explanation may be the fact that based on the new general population census the NBS estimates more exactly the number of migrants. But this does not mean that the number of migrants is decreasing but rather that previous figures on migration were overestimated.

envelope”. According to our estimates, some private companies conceal about 50-60% of the real salary incomes. The mixed capital or foreign capital companies pay salaries that are on the average 25-30% higher than in economy on the whole.

Still, along with the fact that they are an indicator of a greater fiscal transparency, greater salaries are also an indicator of more advanced managing and marketing practices.

In 2006 the issue of growing salary arrears resurfaced. This considerably erodes the reported salary increase. If in November 2005 the debts rose to 108 million MDL, then in November 2006 reached 130 million. According to our estimates they represent about 10-12% of the monthly salary fund. The main companies that have salary arrears to their employees are the agribusinesses, from the private and public sector, as well as some budget-funded sectors. Finally, salary arrears are the result of the lack of restructuring of the private and public spheres of Moldovan economy.

The fast increase in labour pay in some sectors in the private and budgetary spheres, unsustained by respective increase in labour productivity, leads to rising costs as well as prices. Due to this fact, the efficient sectors are forced to compensate the inefficiency of the budgetary sector. The salary rise led to the emergence of distortions within the budgetary system, where the salaries in certain branches are much higher than in other branches. Particularly, the average salary in the public administration is actually twice higher than a salary received by a teacher or a doctor. We see no plausible reason that would justify such a salary distribution in the public sector.

# Republic of Moldova: basic economic indicators

	annual			2006												Informative				
	2003	2004	2005	Note	M1	M2	M3	M4	M5	M6	M7	M8	M9	M10	M11	M12	Note	2003	2004	2005
OUTPUT																				
GDP, the real growth, %	6,6	7,4	7,1	cumul., Q/Q	-	-	6,2	-	-	5,0	-	-	4,6		-	4,0e	Q3/Q3	5,4	5,7	8,4
GDP/capita, USD, market price	548	720,0	860,0	cumul., Q/Q	-	-	191	-	-	416	-	-	735		-	961e	Q3/Q3	392	563	674
Industrial production, real growth, %	15,6	8,2	6,3	cumul.	-1	1,3	-0,3	-5,9	-6,9	-6,4	-6,7	-5,7	-7	-7	-7	-6,9	cum., M1-M11	16,4	6,6	6,4
Agricultural production, real growth, %	-13,6	20,8	1,0	cumul., Q/Q	-	-	0,8	-	-	1,8	-	-	-4,0		-	1,0e	Q3/Q3	-19,9	10,5	6
Gross capital investment, % of GDP	18,6	21,2	24,4	cumul., Q/Q	-	-	19,5	-	-	25,5	-	-	27,1	-	-	23,9e	Q3	15,9	18,7	23,4
BUGETARY																				
Global public budget revenues, MDL millions	9417	11322	14528	cumul.	1200	2076	3577	4870	6205	7696	9222	11743	12399	14097	15722	17850	Cum. Q1-Q3	6543,4	7750,6	10263,7
Global public expenditure, MDL millions	9147	11252	13949	cumul.	n.a.	2004	3396	4712	6035	7757	9188	10683	12082	13503	15030	17979	Cum. Q1-Q3	6265,5	7958,0	9732,9
General balance of the public budget, % of GDP	1,0	0,2	1,6	cumul.	-	-	2,15	-	-	-0,33	-	-	0,98	-	-	-0,3	Cum. Q1-Q3	1,47	-0,84	1,85
Granted and public debts, % of GDP	36,0	25,7	23,7	mil. USD	774	768	768	778	802	794	793	793	789	778	814	-	M11	991	869	767
Internal public debt, % of GDP	10,6	11,6	10,3	mil. MDL	3800	3810	3815	3839	3832	3816	3831	3860	3809	3806	-	-	M11	2890	3744	3764
FINANCE																				
Interest for bank credits, MDL, (%)	19,2	20,9	18,9	M	17,9	18,3	18,2	17,8	17,6	17,6	17,6	18,3	18,6	18,7	18,3	18,6	M11	19,8	20,9	17,8
The NMB base rate, (%)	14,0	14,5	12,5	M	12,5	12,5	12,5	12,5	12,5	12,5	12,5	12,5	12,5	13,0	14,0	14,5	M11	13,0	14,5	12,5
Treasury bonds annual interest, (%)	15,1	11,6	3,7	M	3,2	1,8	4,1	6	7,3	8,5	8,4	8,2	8,3	9,1	9,8	12,9	M11	19,7	9,0	4,5
Exchange rate, MDL/USD, at the end of the period	13,22	12,46	12,84	M	12,92	12,97	13,02	13,02	13,22	13,29	13,32	13,32	13,29	13,23	13,19	12,91	M11	13,29	12,48	12,82
Exchange rate, MDL/USD, at the end of the period	16,53	16,95	15,19	M	15,62	15,38	15,71	16,18	17	16,67	16,98	17,06	16,90	16,78	17,35	16,97	M11	15,83	16,55	15,15



	annual			2006												Informative				
	2003	2004	2005	Note	M1	M2	M3	M4	M5	M6	M7	M8	M9	M10	M11	M12	Note	2003	2004	2005
EXTERNAL																				
Total export, FOB, USD millions	1059	1349	1528	Cum., M	66,7	153	251	313	382	468	543	635	719	816	931	1071	Cum. Q1	543,1	701,1	774,7
Total import, FOB, USD millions	1728	2122	2739	Cum., M	140,4	319,6	538	734	944	1162	1388	1613	1843	2109	2366	2626e	Cum. Q1	926,6	1215,6	1563,9
Total trade deficit, % of GDP	-32,0	-30,1	-42,3	Cum., Q	-	-	-44,1	-	-	-49,2	-	-	-43,6	-	-	-47,7	Cum. Q1	-27,0	-25,3	-34,6
Labor remittances, USD millions, net	440	660	867	Cum., Q	-	-	174	-	-	413	-	-	733	-	-	1080e	Cum. Q1	316	421	596
Direct foreign investments, USD millions, net	78	151	225	Cum., Q	-	-	34,2	-	-	97,34	-	-	116,4	-	-	180e	Cum. Q1	31,7	73,4	83,9
Oil price WTI, USD/barrel, c	30,0c	40,9c	57,5c	M, c	65,5	61,2	62,7	69,5	71,5	70,9	73,6	73,4	63,8	58,8	59,0	61,8	M12, c	31,9c	42,7c	59,2c
MONETARY																				
Currency in circulation, increase rate, %	20,9	36,8	24,4	M/M	26,3	22,7	24,2	25,8	28,9	26,4	17,1	13,3	9,1	8,0	11,1	12,6	M11/M11	19,2	26,8	27,2
Money aggregate M2, increase rate, %	25,9	46,9	37,9	M/M	34,8	31,8	31,2	29,5	24,9	25,2	17,7	13,2	7,6	11,8	14,4	12,2	M11/M11	21,4	39,2	41,0
Official reserves, USD millions	302,3	470,2	600,0	M	599	586	593	608	645	633	636	641	648	674	704	775	M11	290	406	568
Commercial credit stock, increase rate, %	44,4	22,2	35,0	M/M	36,2	37,6	41,2	42,6	42,7	41,9	42,1	42,4	37,2	35,3	36,7	37,8	M11/M11	43,9	24,0	30,8
CONSUMPTION																				
Consumer price index	115,7	112,5	110,0	Cum.	101,9	103,3	104,9	106,4	107,7	107,9	107,5	108,4	109,6	111,3	113,2	114,6	M11/December	114,0	110,7	108,5
Retail trade, actual growth, %	18,2	5,6	4,7	Cum. M/M	12,8	13	12	10,1	11	9,8	9,8	10,5	10,2	10,2	10,5	10,6e	M11/M11	20,4	9,3	12,7
Services rendered to the population, actual growth, %	13,3	5,3	9,3	Cum. M/M	7,7	10	7,6	7,7	8	8	7,9	6,1	5,6	5,6	5,5	5,8e	M11/M11	12,0	5,5	9,4
Consumer Confidence index	-	-	-	M	-	-30,6	-	-	-	-	-	-30,6	-	-	-	-	X	X	X	
Average wage per economy, USD	64	89	105	M	110,3	110	117,8	120,2	125,8	137,2	131,7	132,6	135,4	134,5	142,2	168,5	M11	77,0	99,5	116,9
Real wage growth, %	15,4	10,1	6,8	Cum., M/M	12,1	13,8	14,5	13,5	14,3	15,5	15,2	15	14,5	15,0	15,0	16,0	Cum. M1-M11	17,0	10,2	7,0
Unemployment rate, % (ILO methodology)	7,9	8,1	7,3	Q	-	-	8.1e	-	-	6,4	-	-	5,4	-	-	6,0e	Q3	6,6	6,3	6,6

Notes: M1 – January, M2 – February etc.; M- monthly; M/M – the current year month comparing to the respective month from the previous year;

Q1 – first quarter, Q2 – second quarter, etc.; Q – quarterly; Q/Q – the quarter from the current year comparing to the respective quarter from the previous year;

S1 – semester 1;

cumul. – cumulative from January; „-“ – are not applicable or the data are not comparable, e – EXPERT-GRUP estimations; c- EXPERT-GRUP calculations.

Sources: NBS, MF, NBM, EG, The Economist.